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Should Limited Liability Company Membership Interests be Treated as Securities in South Carolina?

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SHOULD LIMITED LIABILITY COMPANY MEMBERSHIP INTERESTS BE TREATED AS SECURITIES IN SOUTH CAROLINA?

I. INTRODUCTION

Limited liability companies (LLCs) are becoming increasingly important in South Carolina commerce.[1] Accordingly, the question of the extent to which investors in LLCs are protected by the securities laws is of increasing importance.

Neither the federal securities statutes nor the South Carolina Uniform Securities Act[2] explicitly address whether LLC membership interests are securities. No case law in South Carolina addresses the issue either.[3] However, the South Carolina Securities Commission has taken a position and adopted a policy (the 1995 Policy Statement) that establishes rebuttable presumptions as to whether LLC memberships[4] are securities and provides a safe harbor for those wishing to avoid falling within the scope of the securities laws.[5] As the Securities Division prepares to propose comprehensive changes in the regulations it administers,[6] an opportunity presents itself to assess the 1995 Policy Statement in light of current trends in securities jurisprudence.

The securities rules are technical and complex, and complying with them is expensive and uncertain.[7] Nevertheless, such rules are important sources of protection for investors, especially unsophisticated ones. Potential and existing LLCs, their members, and their prospective members need clear guidance to

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1. In fiscal year 1997-98, 4,206 LLCs registered in South Carolina. 1997-1998 S.C. SEC. STATE ANN. ACCT. REP., *available at* www.scstatehouse.net/reports/aar98/e08.doc (last visited May 22, 2001). In fiscal year 1998-99 the total value increased to 6,036 filings. 1998-1999 S.C. SEC. STATE ANN. ACCT. REP., *available at* www.scstatehouse.net/reports/aar99/e08.doc (last visited May 22, 2001). In fiscal year 1999-2000, the total climbed to 7,355 filings. 1999-2000 S.C. SEC. STATE ANN. ACCT. REP., *available at* www.scstatehouse.net/reports/aar2000/e08.doc (last visited May 22, 2001).

2. S.C. CODE ANN. §§ 35-1-10 to -1590 (Law. Co-op. 1987 & West Supp. 2000).

3. Martin C. McWilliams, Jr., *Securities Law Issues*, *in* SOUTH CAROLINA LIMITED LIABILITY COMPANIES & LIMITED LIABILITY PARTNERSHIPS § 3, at 3-25 (3d ed. 2000).

4. Memberships are ownership interests in LLCs, resembling shares of stock in a business corporation. McWilliams, *supra* note 3, at 3-6.

5. 3 Blue Sky L. Rep. (CCH) ¶ 51,580 (containing Statement of Policy 95-2—Limited liability company membership interests as securities). At the time the policy statement was issued, the Securities Commissioner was the Secretary of State. Currently, the Securities Commissioner is the state Attorney General.

6. McWilliams, *supra* note 3, at 3-27 ("[T]he Securities Division of the Attorney General's office appears poised to propose comprehensive new regulations under the Uniform Securities Act . . . .").

7. *Id.*

help determine whether the securities laws, with their complexities and protections, will apply to membership interests.

This Comment explores how an update to the 1995 Policy Statement can achieve such guidance. Part II provides a background to the issue of LLC membership interests as securities and includes a discussion of the 1995 Policy Statement and of the legal foundations of the underlying policy. Part III analyzes the current federal and state treatments and draws on the case law to suggest enhancements to the 1995 Policy Statement. In Part IV, the Comment concludes that the basic structure of the 1995 Policy Statement remains a valid and practical set of guidelines. The conclusion recommends minor changes to reflect current trends.

II. BACKGROUND

A. Statement of Policy 95-2

Statement of Policy 95-2 "set[s] forth the circumstances under which the Securities Commissioner will not recommend enforcement action under the South Carolina Uniform Securities Act . . . in connection with the sale of certain membership interests in limited liability companies."[8] The 1995 Policy Statement operates in two ways. First, it creates presumptions with explanations of how the presumptions can be rebutted.[9] Second, it creates a safe harbor for avoiding the status of securities.[10]

The 1995 Policy Statement establishes two rebuttable presumptions: (1) for member-managed LLCs, the policy presumes that membership interests are not securities; (2) for manager-managed LLCs, the policy presumes the opposite, that the interests are securities.[11] For an LLC to be classified as member-managed for this purpose, each member must have "practical and meaningful participation in and control over the managerial decisions" of the LLC.[12] The factors considered in supporting or rebutting the presumptions are taken from the legal setting associated with investment contracts.[13]

The most secure way to rebut an inference that memberships are securities is to be sheltered within the statement's safe harbor.[14] Memberships that satisfy the conditions of the safe harbor will not be considered securities (by the Securities Commissioner and staff) and thus will be "safe" from enforcement actions by the Commissioner.[15]

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8. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(A).
9. *Id.* ¶ 51,580(D).
10. *Id.* ¶ 51,580(E).
11. *Id.* ¶ 51,580(D).
12. *Id.*
13. *Id.*; *see infra* Part II.C.
14. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E).
15. *Id.*

The safe harbor is narrow in its scope of protection. First, the safe harbor itself is not failsafe, as discussed below. Further, even full compliance does not protect the LLC or its members from private civil action under state or federal law or enforcement action by the Securities and Exchange Commission (SEC) under federal law.[16]

The conditions of the safe harbor include:

1. Neither the articles of organization nor the operating agreement may appoint managers or limit the ability of members to manage the LLC.[17]
2. All members must be managers of the LLC, with practical and actual control over management decisions.[18]
3. The LLC must have twenty-five members or less.[19] This condition establishes, per se, that managerial powers are not rendered meaningless by the sheer number of members.[20] The safe harbor provides that LLCs with more than twenty-five members must show that the operating practices of the LLC do not render the members' management power meaningless.[21] Practices considered include the following: "[t]he nature of the business, the need and schedule for regular meetings, the members' right to call special meetings, the availability of proxy voting, the sophistication and geographical distribution of the members, and similar factors."[22]
4. The LLC must not depend on special skills of the promoter or some other person for profitability.[23] In other words, the members must not rely substantially on the promoter to manage the operations of the enterprise because the success of the enterprise hinges on the promoter's actions. Alternatively, the issuer of membership interests must reasonably believe that every member possesses the knowledge and skill needed to make the enterprise succeed, without the efforts of the promoter or another person.[24]

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16. Although compliance with the 1995 Policy Statement will not be binding on a South Carolina court in a private civil action, such compliance would be persuasive. McWilliams, *supra* note 3, at 3-27.

17. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E)(1).

18. *Id.* ¶ 51,580(E)(2).

19. *Id.* ¶ 51,580(E)(3).

20. *Id.*

21. *Id.*

22. *Id.*

23. Blue Sky L. Rep. (CCH) ¶ 51,580(E)(4).

24. *Id.*

5. The articles of organization and the operating agreement must not establish other special conditions that effectively render a member's management powers meaningless.[25]

Item five in the foregoing list, "special conditions," leaves a door open for disqualification from the safe harbor. Well-advised LLCs wishing to use the safe harbor will apply to the Securities Division staff for letters confirming compliance.[26]

B. The Limited Liability Company and Securities Regulation

1. A Brief History of Securities Regulation

Securities regulation began in the United States in the early 1900s with state law.[27] States sought to protect their citizens from dealers in worthless securities.[28] Today, every state has a blue sky law; many, including South Carolina, are modeled after the Uniform Securities Act.[29] The Uniform Act contains four parts, covering the following: (1) protection of investors from fraud; (2) regulation of securities brokers and dealers; (3) registration of transactions in securities; and (4) definition of securities, including exemptions from registering certain transactions.[30] Following the onset of the Great Depression, Congress moved to fill gaps in the state laws to protect investors, passing the Securities Act of 1933 and the Securities Exchange Act of 1934.[31] These laws were well-developed before the advent of the LLC. As such, the development of securities jurisprudence did not take into account the hybrid nature of the LLC.

2. The LLC

The LLC is becoming an attractive vehicle for conducting business, potentially combining the tax advantages of a partnership and the limited

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25. *Id.* ¶ 51,580(E)(5).

26. McWilliams, *supra* note 3, at 3-27.

27. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION, § 1, at 9 (3d ed. 1995). Kansas had one of the first securities statutes. *Id.* The law was meant to protect locals from being taken by eastern promoters who sought to "'sell building lots in the blue sky,'" giving rise to the name blue sky law. *Id.* (quoting Mulvey, *Blue Sky Law*, 36 CAN. L.T. 37 (1916)).

28. JAMES D. COX ET AL., CORPORATIONS § 27.3, at 27.5 (Supp. 2000).

29. LOSS & SELIGMAN, *supra* note 27, at 9-10.

30. *Id.* at 10-11.

31. COX ET AL., *supra* note 28, § 27.1, at 27.2.

liability of a corporation.[32] Most states, including South Carolina, have enacted statutory requirements that govern establishing and operating an LLC.[33] While most states have LLCs, the states differ as to whether or to what extent membership interests in LLCs are regulated as securities.[34] The issue must be addressed by LLCs when they form and by members when they transfer memberships.[35]

Membership interests in LLCs are not represented by stock, but rather they closely resemble interests in partnerships.[36] In addition to the tax advantages and limited liability of the LLC, its popularity can be attributed to its flexibility.[37] The LLC can operate like a corporation, but with many of the corporate formalities relaxed, or it can be set up to resemble a partnership.[38] One example of this flexibility is the management structure. The LLC can opt for a member-managed structure, much like a general partnership, or a manager-managed structure, like a corporation or limited partnership.[39]

Operating agreements and articles of organization detail management provisions of the LLC.[40] Many LLC statutes allow the parties great latitude in customizing the governance framework of the LLC.[41] In the securities context, this framework can be critical. As seen in the 1995 Policy Statement, the operating agreement and management structure are looked to in assessing whether the memberships are securities.[42]

C. *Foundations of the 1995 Policy Statement: The* Howey Test *and* Williamson v. Tucker

The South Carolina Uniform Securities Act provides a laundry list of what interests are considered securities, but the Act does not list LLC membership interests.[43] The Act does list investment contracts,[44] and therefore the primary foundation for the 1995 Policy Statement is based on whether an LLC

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32. COX ET AL., *supra* note 28, § 1.11, at 1.33, 1.37. Note that LLCs can "check-the-box" to choose the form of taxation, either like a partnership or corporation. Thomas C. Stanley et al., *Finally, Real Tax Simplification: Check-the-Box Regulations Published by the IRS*, S.C. LAW., Sept.-Oct. 1997, at 20.

33. Stanley et al., *supra* note 32, at 20; *see, e.g.*, Uniform Limited Liability Company Act of 1996, S.C. CODE ANN. § 33-44-101 to -1207 (West Supp. 2000).

34. *See* 1 Blue Sky L. Rep. (CCH) ¶ 6551 (presenting a tabular summary of how each state addresses the issue of LLC memberships as securities).

35. McWilliams, *supra* note 3, at 3-1.

36. *Id.*

37. *See generally* COX ET AL., *supra* note 28, § 1.12 (describing the options available in operating an LLC).

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. *See supra* Part II.A.

43. S.C. CODE ANN. § 35-1-20 (Law. Co-op. 1987).

44. *Id.* § 35-1-20(12).

membership interest is an "investment contract."[45] The United States Supreme Court decision *SEC v. W.J. Howey Co.*[46] established a three-prong test to determine whether an interest is an investment contract. The 1995 Policy Statement focuses closely on the third prong in *Howey* and analogizes LLCs to partnerships, using the Fifth Circuit's *Williamson v. Tucker*[47] analytical basis for determining if general partnership interests are securities.[48]

1. The Howey *Test*

In *Howey* the SEC sought to restrain the W.J. Howey Company from selling securities in an unregistered transaction in violation of the federal Securities Act of 1933.[49] The key issue in the case was whether Howey was selling securities.[50] Howey sold a fraction of its interests in citrus groves in Florida, and its sister company, Howey-in-the-Hills Service, provided cultivating and developing services to the land purchasers through service contracts offered at the time of sale.[51] The land purchaser was free to buy the land without contracting with Howey-in-the-Hills.[52] However, eighty-five percent of the purchasers did contract with the sister company.[53]

The service contract gave Howey-in-the-Hills a leasehold interest in the land and "'full and complete' possession of the acreage."[54] The purchasers were generally non-residents of Florida and could not have cultivated the property themselves.[55] Thus, the company was given complete control over cultivating the property.[56]

The United States Supreme Court ruled that the combination of a land sale and a service contract constituted an investment contract and was therefore subject to the provisions of the Securities Act of 1933.[57] After first noting that the Securities Act of 1933 fails to define an "investment contract," the Court established a three-prong test to define the term.[58] The Court defined an investment contract as "[1] a contract, transaction or scheme whereby a person

45. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(C).
46. 328 U.S. 293 (1946).
47. 645 F.2d 404 (5th Cir. May 1981).
48. *See generally* 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E) (establishing safe harbor components that parallel the *Williamson* analysis).
49. *Howey*, 328 U.S. at 294.
50. *Id.* at 297.
51. *Id.* at 295.
52. *Id.*
53. *Id.*
54. *Id.* at 296.
55. *Howey*, 328 U.S. at 296.
56. *Id.*
57. *Id.* at 299.
58. *Id.* at 298-99.

invests his money [2] in a common enterprise and [3] is led to expect profits solely from the efforts" of others.[59]

Like most jurisdictions, South Carolina courts have adopted the *Howey* test.[60] However, they have modified the word "solely" in the third prong of the test.[61] In *O'Quinn v. Beach Associates,*[62] the South Carolina Supreme Court refined the third prong of *Howey* by stating that "investment contracts may be found where the investor has duties that are nominal and insignificant or where the investor lacks any real control over the operation of the enterprise."[63] Since most transactions under consideration concern investments of money in a common enterprise, *Howey*'s third prong becomes the critical issue in determining if an investment contract, and therefore a security, exists.[64]

2. Williamson v. Tucker *and Investor Control*

In *Williamson v. Tucker*[65] the United States Court of Appeals for the Fifth Circuit, in the context of evaluating general partnership interests as securities, provided an analytical basis for determining if the third prong of *Howey* is met. Before *Williamson* a "strong line of authority" held that general partnership interests were never securities, that the third prong of *Howey* was not met.[66] *Williamson* rejected the per se rule.[67] The court reached the issue of whether certain joint ventures are "securities" under the federal Securities Act of 1933 and established that, for a general partnership, the third prong of the *Howey* test would be satisfied (and thus partnership interests would be securities) when: (1) an agreement exists among the partners placing control in the hands of certain managing partners; or (2) a general partner lacks the business expertise or experience to exercise partnership powers; or (3) the partners are forced to

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59. *Id.*

60. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(C); *see e.g.*, Garrett v. Snedigar, 293 S.C. 176, 180, 359 S.E.2d 283, 287 (1987) (citing *Howey* as the seminal case on the issue of whether a transaction is an investment contract).

61. *Garrett*, 293 S.C. at 180, 359 S.E.2d at 285. The federal courts have also softened the "solely" element. *See, e.g.*, SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir. 1973) (adopting a test that determines if the efforts made by those other than the investor in generating profits were significant efforts).

62. 272 S.C. 95, 249 S.E.2d 734 (1978).

63. *Id.* at 105, 249 S.E.2d at 739.

64. McWilliams, *supra* note 3, at 3-9 to -10; *see* LOSS & SELIGMAN, *supra* note 27, at 186-89 (discussing the first two prongs of the *Howey* test).

65. 645 F.2d 404 (5th Cir. May 1981).

66. Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069, 1084 (1992) (citing a list of authorities holding general partnership interests are not securities); *see also* McWilliams, *supra* note 3, at 3-11 ("At one time, the presumption [that general partnership interests were not securities] was so strong as to amount to a *per se* rule.").

67. *Williamson*, 645 F.2d at 422; *see also* Park McGinty, *The Limited Liability Company: Opportunity for Selective Securities Law Deregulation*, 64 U. CIN. L. REV. 369, 392-96 (1996) (discussing *Williamson* and its rejection of a per se rule).

rely on non-replaceable expertise of a manager or promoter.[68] *Williamson*'s three-part test for partnerships has been widely borrowed for evaluation of LLC memberships.[69] Although other legal analyses exist to determine whether an interest is an investment contract[70] or another security interest,[71] the single most common approach by federal and state authorities in deciding whether LLC interests are securities is the *Howey/Williamson* analysis.[72]

The 1995 Policy Statement also uses the *Howey* test as elaborated by *Williamson* to develop both the underlying policy that interests in member-managed LLCs do not constitute securities while interests in manager-managed LLCs do, and the elements of the safe harbor.[73]

D. Federal Treatment of the Issue

How federal courts address the issue of LLC memberships as securities is critical in South Carolina because South Carolina courts base their definitions of securities on federal interpretations.[74] The federal courts have ruled on four cases that address the issue: two cases concerning member-managed LLCs and two cases concerning manager-managed LLCs.[75]

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68. *Williamson*, 645 F.2d at 423.

69. *See, e.g.*, Nutek Info. Sys., Inc. v. Ariz. Corp. Comm'n, 977 P.2d 826, 833 (Ariz. Ct. App. 1998) (analyzing all three parts of the *Williamson* test).

70. For example, the "risk capital" test is an alternative test in determining if an interest is an investment contract. For a discussion of this test and how it relates to LLC memberships, see Sargent, *supra* note 66, at 1092-95.

71. One possibility is that the interest is stock. *See* Great Lake Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376, 385 (D. Del. 2000) (discussing *United Housing Found., Inc. v. Forman*, which defines the meaning of stock as a security); *see also* McWilliams, *supra* note 3, at 3-6 to -8 (analyzing if LLC memberships are stock); Elaine A. Welle, *Limited Liability Company Interests as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 DENV. U. L. REV. 425, 473-78 (1996) (detailing the "characteristics of stock" test).

72. *See* 1 Blue Sky L. Rep. (CCH) ¶ 6551 (providing a state-by-state summary of how LLC interests are analyzed); *see also* SEC v. Shreveport Wireless Cable TV P'ship, 1998 WL 892948 (D.D.C. 1998) (applying *Williamson* to determine if a partnership interest is a security).

73. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E).

74. McWilliams, *supra* note 3, at 3-6.

75. *See* Great Lake Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376 (D. Del. 2000) (concerning a manager-managed LLC); KFC Ventures, L.L.C. v. Metaire Med. Equip. Leasing Corp., 2000 WL 726877 (E.D. La. 2000) (concerning a manager-managed LLC); Keith v. Black Diamond Advisors, Inc., 48 F. Supp. 2d 326 (S.D.N.Y. 1999) (concerning a member-managed LLC); SEC v. Parkersburg Wireless Ltd. Liab. Co., 991 F. Supp. 6 (D.D.C. 1997) (concerning a member-managed LLC).

1. The Member-Managed Cases

The federal courts first addressed whether LLC membership interests are securities in *SEC v. Parkersburg Wireless, LLC*,[76] which concerned a member-managed LLC. In *Parkersburg* an LLC sold memberships to over seven hundred people in forty-three states.[77] Many of the investors were unemployed or retired.[78] The court applied the three-prong *Howey* test to determine if the memberships qualified as investment contracts under the Security Act of 1933.[79] In analyzing the third prong, the court cited *Williamson* but did not expressly compare the facts of the case to the three *Williamson* scenarios.[80] Instead, the court concluded that the "investors' hoped-for profits clearly were to be derived from the efforts of individuals other than the investors themselves."[81] The court ignored the theoretical fact that the operating agreement provided members with the right to manage and focused on the realities of the situation, concluding that the investors were too numerous and too physically dispersed to "manage" the company in a meaningful way.[82]

In *Keith v. Black Diamond Advisors*,[83] another member-managed LLC case, the District Court for the Southern District of New York also applied *Howey* to determine whether an LLC membership interest was a security.[84] In *Black Diamond*, as in *Parkersburg*, the court focused on the third prong of the *Howey* test: "whether [the plaintiff] invested in [the LLC] with the intention of deriving profit from the managerial or entrepreneurial efforts of others."[85] Based on precedent taken from partnership law, including *Williamson*, the court concluded that the plaintiff's interest was not a security.[86] The court emphasized that the plaintiff did maintain power over the management of the LLC, just not as much power as he had expected.[87]

The decisions in *Parkersburg* and *Black Diamond* illustrate that whether an LLC is nominally member-managed is not dispositive as to whether the

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76. 991 F. Supp. 6 (D.D.C. 1997). The issue first came to the federal courts in *SEC v. Vision Communications, Inc.*, 1994 WL 326868 (D.D.C. 1994). The court ultimately did not address the issue, but did grant an injunction, suggesting that the interests were securities. *Id.* at *1; *see also* Welle, *supra* note 71, at 432-35 (discussing the case).

77. *Parkersburg*, 991 F. Supp. at 7.

78. *Id.* at 8.

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* at 9 n.3.

83. 48 F. Supp. 2d 326 (S.D.N.Y. 1999).

84. *Id.* at 332-34.

85. *Id.* at 332.

86. *Id.* at 333-34. The court also relied on *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240-41 (4th Cir. 1988) (stating "'the mere choice by a partner to remain passive is not sufficient to create a security interest'"), and *Hirsch v. duPont*, 396 F. Supp. 1214, 1220 (S.D.N.Y. 1975) (stating that determining whether a partnership interest is a security does not depend on the degree of responsibility assumed by the partner).

87. *Black Diamond*, 48 F. Supp. 2d at 334.

membership interests are securities. Instead, courts will look at the realities of the management structure. A key distinction between the two cases is the number of members: seven hundred in *Parkersburg*[88] and three in *Black Diamond*.[89] The difference in the number of members was the difference between no management control by the members in *Parkersburg* (and the interests being considered securities)[90] and management control in *Black Diamond* (and the interests not being considered securities).[91]

2. *Manager-Managed LLCs*

In *Great Lake Chemical Corp. v. Monsanto Co.*[92] the United States District Court for the District of Delaware addressed whether a membership in a manager-managed LLC was a security.[93] Monsanto transferred one-hundred percent of the interest in an LLC subsidiary to Great Lake Chemical.[94] When profits from the LLC did not meet expectations, Great Lake Chemical sought to recover its losses in an action for securities fraud.[95]

The district court undertook a thorough determination as to whether the interests were securities. First, the court analyzed whether Great Lake Chemical's interest was stock.[96] After the court concluded that the interest was not stock, it applied the *Howey* test to determine if the interest was an investment contract.[97] The court focused its analysis on the "solely from the efforts of others" prong.[98] The court stated that "the terms of the operating agreement of each LLC will determine whether its membership interests constitute securities," refusing to apply the presumptions with respect to general partnerships (not securities) and limited partnerships (securities).[99]

The LLC at issue in the case was manager-managed and the operating agreement expressly stated that the members had no right to manage or to control the company, or even to participate in its management.[100] Sole authority was given to a board of directors.[101] The agreement also stated that members had the power to remove any manager with or without cause and to dissolve the

88. *Parkersburg*, 991 F. Supp. at 7.
89. *Black Diamond*, 48 F. Supp. 2d at 328.
90. *Parkersburg*, 991 F. Supp. at 8.
91. *Black Diamond*, 48 F. Supp. 2d at 334.
92. 96 F. Supp. 2d 376 (D. Del. 2000).
93. *Id.*
94. *Id.* at 381.
95. *Id.* at 377.
96. *Id.* at 387-89. The analysis follows an excellent summary of the qualities of an LLC and the major federal cases governing the issue of "novel instruments" as securities. *Id.* at 383-87.
97. *Id.* at 389-93.
98. *Great Lake Chemical Corp.*, 96 F. Supp. at 390-92.
99. *Id.* at 392.
100. *Id.* at 378.
101. *Id.* at 392.

company.[102] The court found the removal power sufficient to hold that the third prong of *Howey* was not satisfied and that the interest, thus, was not a security.[103]

More recently, the United States District Court for the Eastern District of Louisiana ruled on the issue in *KFC Ventures, L.L.C. v. Metairie Medical Equipment Leasing Corp.*[104] The plaintiff purchased a fifteen percent interest in Open MRI, LLC, and the defendant was to purchase an eighty-five percent interest in the LLC by contributing equipment and leaseholds.[105] The operating agreement specified that Open MRI was to be a manager-managed LLC and designated the defendant as the manager.[106] In resolving the securities claim, the court applied the *Howey* test to the LLC interests.[107]

The court's analysis hinged on the third prong of the test.[108] As with *Great Lakes Chemical*, the court here focused on the operating agreement.[109] The agreement granted the manager "'full, exclusive, and complete discretion, power, and authority . . . to manage, control, administer, and operate the business and affairs of the Company.'"[110] The court found that the plaintiff had virtually no control over the business.[111] Although the plaintiff could participate in votes related to business operations, the votes required a majority to pass, including votes to remove the manager.[112] With only a fifteen percent voting interest, the plaintiff could never assert control.[113] As such, the success of the enterprise was derived solely by the efforts of others and the membership interest was deemed a security.[114]

Great Lake Chemical and *KFC Ventures* represent cases in which the courts ruled on membership interests for manager-managed LLCs where the purchaser of the interests was a company, not an unsophisticated member of the public. The courts came to opposite conclusions.[115] The obvious distinction in the two cases is the element of control.[116] Great Lakes Chemical could replace the managing board, while KFC Ventures' votes were meaningless and could not affect day-to-day management.

E. State Treatment of the Issue

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102. *Id.*
103. *Id.*
104. 2000 WL 726877 (E.D. La. 2000).
105. *Id.* at *1.
106. *Id.*
107. *Id.* at *2.
108. *Id.*
109. *Id.* at *2-3.
110. *KFC Ventures*, 2000 WL 726877, at *3.
111. *Id.* at *2.
112. *Id.*
113. *Id.*
114. *Id.* at *3.
115. *See supra* notes 92-114 and accompanying text.
116. Great Lake Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376 (D. Del. 2000); *KFC Ventures*, 2000 WL 726877, at *3.

Many states have addressed the issue of whether LLC membership interests are securities by applying *Howey*, while some states have used legislative means to resolve the problem.[117] These treatments address the issue as a matter of state law and do not affect federal consideration of LLC interests as securities in the individual states.

1. Statutes

Alaska, California, Indiana, Iowa, Nebraska, Nevada, New Hampshire, New Mexico, Ohio, Pennsylvania, and Wisconsin have statutes that expressly define LLC interests as securities.[118]

While the definitions of securities in these states include LLC interests, most states have exceptions or exemptions that remove certain LLC interests from consideration as securities.[119] For example, in California, the definition of a security excepts "a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the [LLC]."[120] Indiana's definition of a security has a similar exception.[121] Iowa's statute goes further, excepting membership interests from being treated as securities if the person claiming the exception can prove that all members are actively engaged in management; however, it provides that circumstances such as members voting or having the right to vote, or the right to information or to participate in management do not establish that all members actively engage in management.[122] New Hampshire excepts professional LLCs.[123]

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117. For a state-by-state summary of how LLC interests are analyzed, see 1 Blue Sky L. Rep. (CCH) ¶ 6551.

118. *See* ALASKA STAT. § 45.55.990 (Michie 1998); CAL. CORP. CODE § 25019 (West 1977 & Supp. 2000); IND. CODE ANN. § 23-2-1-1 (Michie 1999); IOWA CODE ANN. § 502.102 (West 1999 & Supp. 2000); NEB. REV. STAT. § 8-1101 (1997); NEV. REV. STAT. ANN. § 90.295 (Michie 1999); N.H. REV. STAT. ANN. § 421-B:2 (1998); N.M. STAT. ANN. § 58-13B-2 (Michie 1997 & Supp. 2000); OHIO REV. CODE ANN. § 1707.01 (Anderson 1997 & Supp. 1999); PA. STAT. ANN. tit. 70, § 1-102 (West 1994 & Supp. 2000); WIS. STAT. ANN. § 551.02 (West 1998 & Supp. 1999).

119. An exception, as used here, means that within the definition of a security, the statute expressly limits its application under certain circumstances. Under those situations, the interest is not a security. An exemption means that the securities laws specifically excuse a security from the statutory registration requirements. The interest is a security; it just does not need to be registered. *See* McWilliams, *supra* note 3, at 3-28 to -38 (discussing federal and South Carolina registration requirements and exemptions). When a state statute excepts or exempts the LLC membership interests from security regulations, the LLC interests are not subject to a *Howey* analysis in the courts.

120. CAL. CORP. CODE § 25019 (West 1977 & Supp. 2000).

121. *See* IND. CODE ANN. § 23-2-1-1 (Michie 1999) ("'Security' does not include: . . . an interest in a[n LLC] . . . if the person claiming that the interest is not a security can prove that all members of the [LLC] . . . are actively engaged in the management of the [LLC]. . . .").

122. IOWA CODE ANN. § 502.102 (West 1999 & Supp. 2000).

123. N.H. REV. STAT. ANN. § 421-B:2 (1998).

Statutes of other states except LLC membership interests in different ways. Nebraska and Pennsylvania exclude the interest if the member enters into a written commitment to manage the LLC actively and all members are engaged in managing.[124] Wisconsin's exception applies if the number of members does not exceed fifteen and the LLC is member-managed.[125] Wisconsin's statute presumes the LLC membership is excepted if the LLC is member-managed and has thirty-five members or less.[126]

North Carolina does not have an explicit exception in its securities definition.[127] Instead, the North Carolina rules state that LLC interests are presumed to be securities if the articles provide that all members are not necessarily managers or if a member-managed LLC has more than fifteen members.[128]

Many states, rather than expressing an explicit exception to their securities definition, provide characteristics of the LLC that exempt the securities from the registration process.[129] Some of these exemptions are quite limited. For example, Indiana exempts the interest if the issuer is an LLC and the purchaser is a person with at least ten percent voting interest in that LLC.[130] Pennsylvania exempts membership interests in an LLC rendering one or more professional services.[131]

Of the remaining statutory treatments, most exempt those LLCs which meet a complex list of characteristics. For example, New Hampshire's statute provides an exemption for LLC interests when the LLC has its principal office in New Hampshire, the number of members after the sale of the interests does not exceed ten, no commission was paid in the transfer of the interest, no advertising was made, and all sales concluded within sixty days of the start of business.[132] New Mexico, Ohio, and Vermont have similar lists.[133]

Some states do not expressly include LLC membership interests as securities, yet have exemptions that cover certain LLC interests. Some exemptions are focused, like in North Dakota, where membership interests in an LLC that are distributed to current members are exempt.[134] In Michigan and

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124. NEB. REV. STAT. § 8-1101 (1997); PA. STAT. ANN. tit. 70, § 1-102 (West 1994 & Supp. 2000).

125. WIS. STAT. ANN. § 551.02 (West 1998 & Supp. 1999).

126. *Id.*

127. N.C. GEN. STAT. § 78A-2 (1999).

128. 2A Blue Sky L. Rep. (CCH) ¶ 43,474.

129. For a tabular summary of how each state addresses the issue of LLC memberships as securities, see 1 Blue Sky L. Rep. (CCH) ¶ 6551.

130. IND. CODE ANN. § 23-2-1-2 (Michie 1999).

131. PA. STAT. ANN. tit. 70, § 1-202 (West 1994 & Supp. 2000).

132. N.H. REV. STAT. ANN. § 421-B:17 (1998 & Supp. 2000).

133. N.M. STAT. ANN. § 58-13B-27 (Michie 1997 & Supp. 2000); OHIO REV. CODE ANN. § 1707.03 (Anderson 1997 & Supp. 1999); 3A Blue Sky L. Rep. (CCH) ¶ 58,441.

134. N.D. ADMIN. CODE § 10-04-06 (1995 & Supp. 1999).

Arkansas, the state exempts LLC membership interests in a professional LLC.[135]

Kentucky also has an exemption for professional LLCs, but the exemption requires additional characteristics.[136] The LLC must be incorporated in the state (or a state with similar incorporation laws) and comply with the appropriate laws regarding ownership and transfer restrictions.[137] Also, the seller must believe that the buyer is a professional person purchasing for an investment (as opposed to resale) and believe that the buyer must have access to information concerning the LLC.[138]

Other state exemptions are less focused. In addition to its professional LLC exemption, Arkansas's statute provides for discretionary exemptions for securities purchased to form the LLC and transactions between the LLC and existing members (formed by seven or fewer members).[139]

In Kentucky, if the LLC is manager-managed according to the articles or operating agreement or has more than thirty-five members, the interest is presumed to be a security.[140] If the LLC is member-managed and the number of members does not exceed thirty-five, the interests are presumed to not be securities.[141] Membership interests for a member-managed LLC with less than fifteen members are excepted from the definition of a security.[142]

Kansas provides an exemption for LLC interests formed under Kansas law when the number of sales does not exceed twenty, the seller believes the purchase is for an investment, the purchaser does not pay a commission, and the issuer does not advertise through a general solicitation.[143] Similarly, Maine's exemption applies to LLC interests offered for sale by an LLC organized under Maine law and whose members do not exceed ten, either before or after the sale.[144] A different exemption limits the number to ten members before the sale and twenty-five after the sale.[145] In either case, the issuer may not advertise to the general public.[146] To qualify for the "twenty-five member" exemption, the issuer must notify the state and provide a copy of the notification to each offeree.[147]

2. *Interpretations of the Definition*

135. 2 Blue Sky L. Rep. (CCH) ¶ 32,630; 1A Blue Sky L. Rep. (CCH) ¶ 10,480.
136. 2 Blue Sky L. Rep. (CCH) ¶ 27,415.
137. *Id.*
138. *Id.*
139. 1A Blue Sky L. Rep. (CCH) ¶ 10,480.
140. 2 Blue Sky L. Rep. (CCH) ¶ 27,428L.
141. *Id.*
142. *Id.*
143. KAN. STAT. ANN. § 17-1262 (1995).
144. 2 Blue Sky L. Rep. (CCH) ¶ 29,432.
145. *Id.*
146. *Id.*
147. *Id.*

While many state administrative proceedings have addressed the issue of whether LLC membership interests are securities, state case law has rarely addressed the issue. The only state court case addressing whether LLC membership interests are securities is *Nutek Information Systems v. Arizona Corporation Commission.*[148] In *Nutek* the Arizona Court of Appeals found that the LLC memberships at issue in the case were investment contracts and thus securities, affirming a ruling by the Arizona Corporation Commission.[149]

In *Nutek* the issuer of the membership interests was attempting to establish a regional communication system to be operated by different LLCs throughout the western United States.[150] The issuer provided potential offerees with initial offering material, and investors were told that they would receive a Membership Summary providing them with additional information and an opportunity for a refund.[151] Over nine-hundred investors invested more than ten million dollars in the enterprise.[152] Members were sent the Membership Summary (after the Arizona Corporation Commission had filed a notice to cease and desist) that included an opportunity for a refund.[153] The Membership Summary also required investors to ratify prior actions by the LLCs, which included establishing the promoter's company as manager.[154] Although the promoter's company had management responsibility, the articles of incorporation for each LLC did provide that the LLC was member-managed.[155]

The court analyzed the facts in this case under the *Howey* test, as modified by *Turner* and elaborated by *Williamson.*[156] As in the federal cases, the third prong of the *Howey* test was the only relevant issue as to whether an investment contract existed.[157] The court found all three *Williamson* factors present and the third prong of *Howey* satisfied.[158] Under the first *Williamson* factor, power to control, the court looked beyond the facial evidence of the grant of power to the investors in the articles of incorporation, to the practical control of each investor.[159] The following factors moved the court to find that the members did not have practical control of the LLCs: the management agreement with the promoter's company; that the agreement was entered into prior to the investors becoming members (and therefore ratified by them when

148. 977 P.2d 826 (Ariz. Ct. App. 1998).
149. *Id.* at 827-28.
150. *Id.* at 828.
151. *Id.*
152. *Id.*
153. *Id.* at 829.
154. *Nutek*, 977 P.2d at 829.
155. *Id.* at 831.
156. *Id.* at 830.
157. *Id.*
158. *Id.* at 835. The court, relying on the *Williamson* opinion, explicitly stated that the three factors are not the only factors to be considered, but "other factors may come into play." *Id.* at 831 n.5. These other factors would depend on the facts of the case. *Id.* However, the court limited its analysis to the three factors in *Williamson. Id.* at 832-35.
159. *Id.* at 831-32.

they became members) coupled with the large number of members; and that the members were "geographically dispersed."[160]

For the second *Williamson* factor, experience and knowledge of the investor, the court ruled that the factor related not to general business knowledge and experience, but to knowledge and experience of the specific enterprise.[161] The court reasoned that the principle underlying the factor was whether lack of knowledge prevented the investor from exercising meaningful control over the investment.[162] If the investor cannot understand the actual business, the investor is more likely to rely on the efforts of others for profits.[163] The court found that in this case involving hi-tech communications networks, the investors did not understand the nature of the business.[164]

For the final *Williamson* factor, dependency on unique talents of the promoter or manager, the court found that the investors had to rely on the efforts of the promoter.[165] The promoter's company was under contract to manage the enterprise, and he could be replaced only for gross negligence or fraud.[166] Also, his management effort combined individual LLCs into a network, and the network was essential for the success of the enterprise.[167] Thus, the *Nutek* court concluded that the interests in the LLC were securities.[168]

Like the court in *Nutek*, state administrative proceedings have used *Howey* to resolve the issue of whether LLC membership interests are securities. A good example is *In re Express Communications, Inc*,[169] in which the Illinois Securities Department found that a promoter who established LLCs to exploit cellular telephone licenses violated the securities laws.[170] The hearing officer, after noting that Illinois rules expanded the coverage of the three prongs of the *Howey* test in determining if an investment contract exists, applied a traditional *Howey* analysis.[171] Under facts very similar to *Nutek*, the hearing officer found that the investors had no practical control over the management of the LLC, even though the articles of incorporation established a member-managed LLC.[172] A key factor was the dispersed and unsophisticated membership whose actual ability to control was stifled by existing management agreements.[173] The

160. *Nutek*, 977 P.2d at 831-32.
161. *Id.* at 833.
162. *Id.*
163. *Id.*
164. *Id.*
165. *Id.* at 834.
166. *Nutek*, 977 P.2d at 834.
167. *Id.*
168. *Id.* at 835.
169. 1993 WL 566300 (Ill. Sec. Dept. 1993) (order of prohibition).
170. *Id.* at *16.
171. *Id.* at *10-11.
172. *Id.* at *14.
173. *Id.*

Department concluded that all three prongs of the *Howey* test were met and the membership interests were securities.[174]

Other typical administrative proceedings have followed similar patterns. For example, in two separate Interpretive Letters, the Idaho Department of Finance found LLC interests to be securities.[175] In one, an LLC with seventy doctors was to be managed by a board of seven.[176] The Department applied both the *Howey* and the risk capital tests and concluded that all of the members would not be involved in management, so the interests were securities.[177] In the other opinion, the Department found an interest in an LLC that was to assemble manufactured items for sale was a security.[178] The LLC was to have from fifty to two-hundred members (employees of the LLC working out of their houses), each owning one interest for $1.[179] The LLC was to be managed by three promoters who had total control of the business.[180] The Department found that the three prongs of *Howey* were satisfied and employed *Williamson* in the rationale.[181]

Maryland has taken a unique position under certain facts.[182] The Securities Division found membership interests in a professional LLC not to be securities.[183] The managing board was to be comprised of directors appointed by the promoter and others voted on by the member doctors.[184] Despite this management structure, the Division ruled that the physicians did not need the protection of the securities regulations.[185]

While quite a few states have addressed whether LLC membership interests are securities, there are still some states that have yet to address the issue either through statutes or cases.[186] However, their securities administrators have weighed into the discussion. Almost uniformly, these states have expressed that they will apply the *Howey* test to determine if the interest is a

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174. *Id.* at *15.

175. Eastern Idaho Physicians Org., P.L.L.C., Idaho Dept. Fin. No-Action Letter, 1994 WL 822475 (Nov. 2, 1994); Santana LLC Request for Interpretive Opinion, Idaho Dept. Fin. No-Action Letter, 1996 WL 774825 (Nov. 6, 1996).

176. Eastern Idaho Physicians Org., P.L.L.C., Idaho Dept. Fin. No-Action Letter, 1994 WL 822475, at *1.

177. *Id.* at *2.

178. Santana LLC Request for Interpretive Opinion, Idaho Dept. Fin. No-Action Letter, 1996 WL 774825, at *3.

179. *Id.* at *1.

180. *Id.* at *2.

181. *Id.* at *3. Note that in this opinion, two years after *Eastern Idaho Physicians Org.*, the risk capital test was not mentioned. *Id.*

182. Greater Baltimore OB/GYN Assoc. LLC, Md. Sec. Div. No-Action Letter, 1997 WL 912158 (Apr. 23, 1997).

183. *Id.* at *5.

184. *Id.* at *3.

185. *Id.* at *5.

186. *See* 1 Blue Sky L. Rep. (CCH) ¶ 6551.

security.[187] A few other states have asserted that they will evaluate the issue on a case-by-case basis, without specifically pointing to the *Howey* test.[188]

III. ANALYSIS

A. How the South Carolina 1995 Policy Statement Compares to Current Trends

The 1995 Policy Statement on LLC interests as securities is in line with the treatment of this issue in the federal courts and in states across the country. As discussed previously, the pillars of reasoning when determining if an LLC interest is a security are the tests embodied in *Howey* and *Williamson*.[189] Federal courts have relied exclusively on the *Howey* test to determine if LLC interests qualify as investment contracts, and the third prong of *Howey* has been evaluated using the *Williamson* test in many cases.[190] State courts and administrative bodies have also relied on *Howey* and *Williamson*.[191] When a state lacks case law on the issue, many state administrators have expressly stated that the *Howey* test would be used to determine if LLC memberships should be treated as securities.[192] This approach is exactly the approach taken in the 1995 Policy Statement.[193]

The 1995 Policy Statement goes further than employing the *Howey* test on a case-by-case basis. The policy establishes rebuttable presumptions as to whether or not an interest is a security.[194] Interests in member-managed LLCs are presumed not to be securities while interests in manager-managed LLCs are

187. For example, in Louisiana, Maryland, Mississippi, Missouri, North Dakota, South Dakota, Utah, Virginia, Washington, and Wyoming, state security administrators said that the *Howey* test would be applied to determine whether the interest was a security. *See id.* In Connecticut, an interpretive release states that the *Howey* test will be used to determine if the interest is an investment contract, while *Williamson* will be used in evaluating the third prong. *See* 1A Blue Sky L. Rep. (CCH) ¶ 14,562.

188. For example, in Colorado, a securities administrator stated, "Each LLC membership interest is considered an investment contract." 1 Blue Sky L. Rep. (CCH) ¶ 6551. "Once an LLC is considered an investment contract, then whether an exemption is available for that LLC interest will be determined on a case-by-case basis." *Id.* In Montana a securities administrator stated, "Each LLC interest is looked at on a case-by-case basis to determine whether it is a security and whether an exemption might apply." *Id.* Similarly, in New York a securities administrator stated that they would look at the structure of the LLC. If members were passive, the LLC interest would be an investment contract. *Id.*

189. *See supra* Part II.C.

190. *See, e.g.*, Keith v. Black Diamond Advisors, Inc., 48 F. Supp. 2d 326 (S.D.N.Y. 1999) (applying *Williamson* in evaluating the third prong of the *Howey* test).

191. *See, e.g.*, Nutek Info. Sys. v. Ariz. Corp. Comm'n, 977 P.2d 826 (Ariz. Ct. App. 1998) (redefining the second factor in *Williamson* to mean understanding the nature of the underlying enterprise).

192. *See* 1 Blue Sky L. Rep.(CCH) ¶ 6551; *supra* note 158.

193. *See* 3 Blue Sky L. Rep. (CCH) ¶ 51,580(C).

194. *See id.* ¶ 51,580(D).

presumed to be securities.[195] Many of the cases that have addressed whether LLC interests are securities turn on the issue of management structure; interests in manager-managed LLCs were almost always found to be securities.[196] States that expressly except certain LLCs from their definition of securities usually do so for member-managed LLCs.[197]

In analyzing the 1995 Policy Statement's safe harbor, one must remember the underlying rationale for a safe harbor: providing certainty to LLCs and their members as to whether the LLC membership interests will be treated as securities.[198]

The first two characteristics of the safe harbor look at the operating agreement and the actual management structure of the LLC.[199] In reaching the ultimate question of whether an LLC interest is a security, courts and administrative processes have focused on both the operating agreement and the management realities.[200] How an LLC's operating agreement organizes the management structure and how that structure is implemented day-to-day are the ultimate questions. The other characteristics considered in the 1995 Policy Statement safe harbor flow from these questions.

One such characteristic is the number of members: member-managed LLCs with twenty-five or fewer members are sheltered in the safe harbor.[201] Many states have forged exceptions to their securities definition or exemptions from registration requirements for LLCs ranging in size from ten to thirty-five members.[202] Courts have focused on the number of members as a key issue in analyzing whether the membership interests are securities. In both *Nutek* and *Express Communications* the courts found that the large number of members precluded member management as a practical matter, despite the articles' statements that the LLCs were member-managed.[203]

Another characteristic of the safe harbor is that the promoter for the enterprise cannot possess special qualities essential to the enterprise's

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195. *See id.*

196. *See, e.g.*, KFC Ventures, L.L.C. v. Metairie Med. Equip. Leasing Corp., 2000 WL 726877, at *3 (E.D. La. 2000) (finding LLC interest in a manager-managed LLC a security). *But see* Great Lakes Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376 (D. Del. 2000) (finding LLC interest in a manager-managed LLC not a security).

197. *See, e.g.*, CAL. CORP. CODE § 25019 (West 1977 & Supp. 2000) (excepting member-managed LLC interests from the California definition of a security).

198. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E).

199. *Id.*

200. *See supra* Part II.D. Federal courts in *Great Lakes Chemical* and *KFC Ventures* expressly relied on the operating agreement, while still emphasizing the importance of actual control. *Great Lakes Chem. Corp.*, 96 F. Supp. 2d at 392; *KFC Ventures, L.L.C.*, 2000 WL 726877, at *2-3.

201. *See* 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E)(3).

202. *See* 1 Blue Sky L. Rep. (CCH) ¶ 6551.

203. *See* Nutek Info. Sys. v. Arizona Corp. Comm'n, 977 P.2d 826 (Ariz. Ct. App. 1998); Express Communications, Inc., 1993 WL 566300 (Ill. Sec. Dept. 1993) (order of prohibition).

profitability.[204] The fourth element of the safe harbor contains an alternative way of expressing this characteristic: the interest is sheltered in the safe harbor if the issuer reasonably believes that the purchasers "have such knowledge and experience in the business . . . that each of the members is capable of evaluating the merits and risks of investing in membership interests and the members collectively would be capable of operating and managing the LLC without the specific promoter."[205] As mentioned previously, this quality is taken from *Williamson*[206] and has served as a rationale for courts finding LLC interests to be securities.[207] However, this component adds complexity to the safe harbor.

First, as seen in *Nutek*, an issue may be whether the investors understood the specific nature of the business, not just business in general.[208] Whether the characteristic at issue is general business knowledge or specific knowledge of the technical aspects of the enterprise affects the stringency of the safe harbor requirement.[209] Second, to qualify for the safe harbor, each member must have the capability necessary to operate the enterprise.[210] This language could mean that in the hands of a sophisticated investor the interest is not a security, yet the same interest in the hands of a less sophisticated investor is a security.

The fourth element of the safe harbor implies that more than general business knowledge is needed for the interest to be sheltered in the safe harbor.[211] However, the element could be revised to include specific inquiries that the issuer should make to demonstrate that the issuer's belief as to the capability of the investor was "reasonable"—that is, that the investor possessed specific knowledge related to the nature of the enterprise. Additionally, the element should expressly state that if the safe harbor is not satisfied as to one investor, it is not satisfied for any investor.

The fifth characteristic of the safe harbor states that, for the LLC interest to be sheltered within the safe harbor, "[t]here exists [sic] no other special facts or circumstances which render substantially meaningless the managerial powers permitted to the members by the Articles of Organization and Operating Agreement."[212] Meaningful managerial power is the linchpin in the *Howey* analysis.[213] However, the purpose of the safe harbor is to "provide a measure of business certainty" in transactions involving LLC membership

204. *See* 1 Blue Sky L. Rep. (CCH) ¶ 6551.

205. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E)(4).

206. Williamson v. Tucker, 645 F.2d 404, 423 (5th Cir. May 1981).

207. *See Nutek*, 977 P.2d at 832 (redefining the second factor in *Williamson* to mean understanding the nature of the underlying enterprise).

208. *Id.* at 833.

209. *See id.* (identifying as a key concern whether investors understood the technical nature of the business).

210. *See* 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E)(4).

211. *See id.*

212. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E)(5).

213. *See generally supra* Part II (discussing that in every case and most exceptions and exemptions related to LLC interests as securities, the substantive issue is meaningful management).

interests.[214] This fifth characteristic introduces uncertainty into the equation making the safe harbor illusory. The Securities Commissioner can always point to "special facts or circumstances" to remove an interest from the shelter of the safe harbor with the LLC or member not having any guidance as to what might constitute these circumstances.

To ameliorate the uncertainty, an updated policy could provide specific examples of "other special facts or circumstances." However, in evaluating the facts and circumstances of the cases decided to date, the other four safe harbor characteristics encompass the situations likely to be encountered.[215] The best approach may be to eliminate the fifth element of the safe harbor, easing the associated uncertainty.

B. Other Considerations for the Safe Harbor

Current trends in addressing whether LLC interests are securities could be adopted by the Securities Commissioner to enhance the safe harbor in an updated policy statement. One such element is notice. Notice helps satisfy the underlying policy of the securities laws: protecting the uninformed public from unscrupulous securities dealers.[216] Two examples of states that have a notice element are New Mexico and Maine.[217] New Mexico requires that an offering document be delivered to investors prior to a sale.[218] Maine requires that offerors provide offerees with a copy of the notification of exemption from the securities regulations.[219]

The 1995 Policy Statement could have a similar element: the seller would be sheltered within the safe harbor if the offeree is notified, in writing, that the transaction is not protected by the South Carolina securities regulations. This requirement would pose only a small burden on the LLC and its members.[220] The notice would not need to provide the risks associated with the purchase. Instead, the notice would merely alert the investor that additional diligence is required to ensure that the risks are investigated, since the transaction is not

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214. 3 Blue Sky L. Rep. (CCH) ¶ 51,580(E).

215. Examples of the situations encountered include unsophisticated or geographically dispersed investors (covered in the third safe harbor element), a highly technical enterprise coupled with inexperienced investors (covered in the fourth safe harbor element), and pre-established management contracts (covered in the first and second safe harbor element). *See supra* Part II.D and Part II.E.

216. *See* LOSS & SELIGMAN, *supra* note 27, § 1.

217. *See* N.M. STAT. ANN. § 58-13B-27 (Michie 1997 & Supp. 2000); 2 Blue Sky L. Rep. (CCH) ¶ 29,432.

218. *See* N.M. STAT. ANN. § 58-13B-27 (Michie 1997 & Supp. 2000).

219. *See* 2 Blue Sky L. Rep. (CCH) ¶ 29,432.

220. The benefit of such a notice could extend beyond a no-action letter from the Securities Commissioner. The notice would provide evidence, in a civil or federal action, that good faith measures were taken to protect investors.

protected by the state's securities laws. The policy statement could provide the text of the notice.[221]

Additionally, a special safe harbor characteristic could be established for professional LLCs. The special category would add some flexibility. Several states treat professional LLCs as exceptions to the securities laws.[222] This treatment is warranted since these professionals would know the business of their profession (satisfying the second prong of *Williamson*, even under *Nutek*).[223] The risk that the individual investor will need the protection of the securities laws is low;[224] however, the flexibility that a professional LLC provision in the safe harbor might add would need to be balanced against the policy considerations of limiting liability for certain professions, for example, the practice of law.[225]

Another addition to the safe harbor could be a restriction on advertising. This characteristic is common[226] and would protect investors from dealers who use general solicitations, since it is more likely that an LLC, where members would rely on the efforts of others for profits, would be advertised in a general solicitation.

Certain elements included in other states' treatment of the issue should not be incorporated into an updated policy statement. New Mexico and Vermont's exemptions for LLCs[227] when eighty percent of the revenues stay within the

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221. For example, the policy statement could read:

> This transaction involves the sale of a membership interest in a limited liability company (LLC). The LLC involved in the transaction conforms with the characteristics of the safe harbor designated by the Securities Commissioner in Statement of Policy XX-Y: limited liability company interests as securities. As such, this transaction is not protected by the securities regulations as enforced by the Securities Commissioner. Although the purchaser may have civil remedies under the South Carolina Uniform Securities Act or remedies under federal securities regulations, the purchaser should diligently investigate the risks associated with this investment.

222. States that do not treat interests in professional LLCs as securities include Arkansas, Kentucky, Michigan, New Hampshire, and Pennsylvania. *See supra* Part II.E.1.

223. Nutek Info. Sys. v. Ariz. Corp. Comm'n, 977 P.2d 826, 833 (Ariz. Ct. App. 1998).

224. *See, e.g.*, Greater Baltimore OB/GYN Assoc. LLC, Md. Sec. Div. No-Action Letter, 1997 WL 912158 (Apr. 23, 1997) (finding a professional LLC exempt from the securities regulations because the member physicians did not need protection from the securities laws).

225. The South Carolina Supreme Court has not expressly permitted law firms to practice as LLCs, although many firms currently operate as LLCs in South Carolina. *See, e.g.*, http://www.finkellaw.com (providing the homepage for Finkel & Altman, LLC, a law firm in South Carolina); *see also* Martin C. McWilliams, Jr., *Limited Liability Law Practice*, 49 S.C. L. REV. 359, 367-73 (1998) (discussing practicing law in South Carolina using limited liability business forms).

226. *See, e.g.*, KAN. STAT. ANN. § 17-1262 (1995) (including a restriction against advertising in its exemption for LLC interests); *see also supra* Part II.E (discussing state exemptions, including many exemptions that contain prohibitions against advertising).

227. N.M. STAT. ANN. § 58-13B-27 (Michie 1997 & Supp. 2000); 3A Blue Sky L. Rep. (CCH) ¶ 58,441.

state, seem arbitrary. Although the state can keep close control over sellers, even after the sale, this element fails to protect investors under the initial transaction.

Transaction limits, such as New Mexico's cap that limits the exemption to transactions totaling less than $1,500,000 are less arbitrary.[228] The smaller the amount of money involved in a transaction, the less injury investors could suffer. Still, the Securities Commissioner would need to establish a rationale for setting the dollar limit. The rationale would need to consider the range of dollar values for transactions in South Carolina and draw a line at a point where investors need protection. The other safe-harbor characteristics are likely to draw this line adequately.

Another element that should not be included in the updated policy is a per se rule making interests securities. Although a per se rule would remove any uncertainty for LLCs and their members, this approach was obviously rejected by the Secretary of State in the initial policy and would greatly reduce the attractiveness of the LLC as a business form in South Carolina.

The discussion in this Comment focuses on South Carolina security regulations. LLCs and their members should note that these characteristics do not immunize the membership interests from attack on different fronts:[229]

- membership interests can still be attacked under the federal securities regulations;[230]
- transactions in other states could subject the interests to those states' securities regulations;[231]
- investors have civil remedies available under the securities regulations.[232]

IV. CONCLUSION

The current policy statement on whether LLC membership interests are securities in South Carolina is sound. The statement's legal foundations are consistent with those employed in the federal courts and states throughout the country. When the statement is updated, the Securities Commissioner can enhance the safe-harbor characteristics to reflect positive elements from other

228. *See* N.M. STAT. ANN. § 58-13B-27 (Michie 1997 & Supp. 2000).

229. *See* 3 Blue Sky L. Rep. (CCH) ¶ 51,580(C) ("Issuers and their professional advisors should note that . . . the position taken by the Commissioner [in the 1995 Policy Statement] might not be consistent with the positions taken by the courts and federal and other states' securities administrators.").

230. *See* McWilliams, *supra* note 3, at 3-27.

231. As previously discussed, states have diverse treatments of LLC interests. *See supra* Part II.

232. While the policy statement relates to state enforcement actions only, the cases discussed in Part II.D and Part II.E of this Comment indicate that enterprises that reside in the safe harbor would likely prevail in a civil or federal action. *See* McWilliams, *supra* note 3, at 3-27.

states. Such enhancements include providing a notice element, a special category for professional LLCs, and a limitation on advertising. Additionally, the Commissioner should eliminate the fifth element of the current safe harbor, the characteristic that provides that "special facts or circumstances" could take the enterprise out of the safe harbor. This element is likely redundant in light of the other four elements and adds uncertainty to the safe harbor to the degree that the entire safe harbor may be illusory.

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